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IN THE

Supreme Court of the United States

October Term, 1964

No. 319

ARCH C. SCURLOCK, JAMES M. JOHNSTON and MALCOLM F. SCHOEFFEL,

Petitioners,

v.

SAMUEL MELTZER,

Respondent.

No. 326

ARTHUR W. SLOAN, FRANKLIN C. SALISBURY, and ATLANTIC RESEARCH CORPORATION,

Petitioners,

v.

SAMUEL MELTZER,

Respondent.

BRIEF FOR PLAINTIFF-RESPONDENT IN OPPOSITION TO PETITIONS FOR CERTIORARI

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INDEX

	PAGE
QUESTION PRESENTED	2
STATEMENT OF THE CASE	3
1. The amended complaint	3
2. Other matters before the District Court	5
ARGUMENT	7
POINT I—The Petitions Present No Question of Federal Law	7
POINT II—The Decision Below Presents No Question of General or National Interest	9
POINT III—The Decision Below Is Not in Conflict With Other Authorities	12
CONCLUSION	13

TABLE OF CITATIONS

Cases:

Brown v. Bullock, 194 F. Supp. 207, 228 (SDNY, 1961), aff'd 294 F. 2d 415 (Cir. 2, 1961)	10
Carroll v. N. Y., N. H. & H. R. Co., 141 F. Supp. 456, 457 (D. Mass., 1956)	8
Carruthers v. Jack Waite Mining Co., 14 F. R. D. 475 (SDNY, 1953)	8
Guth v. Groves, 44 F. Supp. 851 (SDNY, 1942)	12
Halprin v. Babbitt, 303 F. 2d 138 (Cir. 4, 1962)	8
Hausman v. Buckley, 299 F. 2d 696 (Cir. 2, 1962)	8
Hawes v. Oakland, 104 U. S. 450 (1882)	8

PAGE

Levitt v. Johnson, CCH Fed. Sec. Law Reporter, Sec. 91413, p. 94641 (Cir. 1, Op. No. 6249, July 8, 1964, not yet officially reported) 10

Levitan v. Stout, 97 F. Supp. 105 (W. D. Ky., 1951) ... 12

Pomerantz v. Clark, 101 F. Supp. 341 (D. Mass., 1951) 8

Shimer v. Milton Mfg. Co., 10 F. Supp. 943 (M. D. Pa., 1935) 12

Squair v. Lookout Mountain Co., 42 Fed. 729, 732-3 (E. D. Tenn., 1890) 12

Steinberg v. Adams, 90 F. Supp. 604, 609 (SDNY, 1950) 8

Steinberg v. Hardy, 90 F. Supp. 167, 169 (D. Conn., 1950) 8

Swanson v. Traer, 354 U. S. 114 (1957) 7

Swanson v. Traer, 249 F. 2d 854 (Cir. 7, 1958) 8

Toebelman v. Missouri-Kansas Pipe Line Co., 41 F. Supp. 334 (D. Del., 1941), rev'd 130 F. 2d 1016, 1022 (Cir. 3, 1942) 8

Tower Hill-Connelsville Coke Co. v. Piedmont Coal Co., 64 F. 2d 817 (Cir. 4, 1933) 12fn

United States v. Employing Plasterers Ass'n, 347 U. S. 186, 188 (1954) 10

Watson v. United States Sugar Refinery, 68 Fed. 769, 773 (Cir. 3, 1895) 12

Ziegler v. Lake St. Elev. R. Co., 76 Fed. 662, 663 (Cir. 7, 1896) 12

PAGE

Statutes and Regulations

Federal Rules of Civil Procedure—Rule 23(b) 2, 10, 12
Equity Rule 94 (104 U. S. IX) 12
Equity Rule 27 (226 U. S. 656) 12

Administrative Decisions

Matter of Atlantic Research Corporation (S. E. C. Dec. 6, 1963, Securities Act Release No. 4657) 4

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BRIEF FOR PLAINTIFF-RESPONDENT IN OPPOSITION TO PETITIONS FOR CERTIORARI

Plaintiff-respondent submits this brief in opposition to the petition for certiorari of defendants Sloan, Salisbury and Atlantic Research Corporation ("Sloan petition") and the separate petition for certiorari of defendants

Scurlock, Johnston and Schoeffel ("Scurlock petition"). Both petitions seek review of a decision of the Court of Appeals for the Fourth Circuit (330 F. 2d 946), which reversed an unreported decision of the District Court for the Eastern District of Virginia.

Jurisdiction in the District Court was based on diversity of citizenship. The suit is a derivative action brought by plaintiff as a stockholder of defendant Atlantic Research Corporation ("Atlantic") against its directors for breaches of their fiduciary duties. The District Court granted defendants' motions to dismiss on the ground that the amended complaint does not comply with Rule 23(b) FRCP, in that it does not allege a demand on the board of directors of Atlantic to bring this action, or reasons for not making such demand (Scurlock pet. 21a). The Fourth Circuit reversed on the ground that the complaint alleges facts sufficient to dispense with a demand on the directors and the stockholders of Atlantic.

The questions presented to this Court by the petitions for certiorari are limited to the issue of demand on the *directors* (Sloan pet. 2; Scurlock pet. 2). No question concerning a demand on the *stockholders* is, therefore, before the Court.

QUESTION PRESENTED

Where the complaint in a stockholder's derivative action brought in the diversity jurisdiction of the District Court sets forth with particularity facts showing that each of the directors is liable for the wrongs alleged in the complaint, must the plaintiff first make a demand upon the directors before he can institute an action on behalf of the corporation?

STATEMENT OF THE CASE

1. The amended complaint.

The summary of the amended complaint ("complaint" hereinafter) set forth in the petitions bears little similarity to the allegations actually made. We must supply the omissions.

Atlantic is a corporation organized under Virginia law (par. 1(c)). The five individual defendants (Scurlock, Sloan, Johnston, Salisbury, Schoeffel) did and do constitute its entire board of directors (par. 3). Defendant Scurlock was and is Atlantic's president; defendant Sloan was and is its executive vice-president (par. 4). Scurlock and Sloan own 21% and 18%, respectively, of Atlantic's common stock. The three other individual defendants, together with their associates and families, own or control other substantial blocks of Atlantic's stock (par. 4).

The market price of Atlantic's stock has been steadily declining since June 1961 (par. 6(c)). As a consequence, the value of defendants' personal stockholdings likewise declined (par. 7).

In order to protect their own personal investments in Atlantic in the face of the falling market, defendants caused Atlantic to spend about $3,900,000 of its funds for purchases of its own stock, which were intended to support the market. The purchases were made through certain intermediaries, to whom Atlantic loaned money in return for promissory notes (pars. 8, 9). The value of the notes was substantially below $3,900,000; so were the shares purchased by Atlantic's intermediaries. The stock purchases and loans served no corporate purpose and resulted

in the diversion of Atlantic's assets from useful and productive purposes (par. 11).

Defendants permitted further diversions of Atlantic's funds. Those funds were used to finance four personal holding companies of defendant Scurlock (Pine Ridge, Texas Capital, Edsall Development, Eastern Associates) (pars. 14-17). Defendants caused Atlantic to enter into unfavorable lease arrangements with these corporations (*ibid.*).

The various diversions charged in the complaint are documented in detail in an opinion of the Securities and Exchange Commission; *Matter of Atlantic Research Corporation* (Dec. 6, 1963, Securities Act Release No. 4657). The Commission suspended trading in Atlantic's stock because of the falsity of Atlantic's published financial statements (par. 12).

After setting forth these substantive claims, the complaint alleges the reason for making no demand upon Atlantic's board of directors, as follows (par. 20):

> "20. Demand upon the board of directors of Atlantic to bring this action would be futile because:
>
> (a) The board of directors is controlled and dominated by the alleged wrongdoers, through their official positions with Atlantic, and by virtue of their very substantial stockholdings;
>
> (b) The directors have participated in the wrongs alleged;
>
> (c) The directors have negligently permitted the aforementioned wrongs to occur and are liable therefor; and

(d) The institution of this action by the directors would place it in hostile hands and would prevent its effective prosecution."

2. Other matters before the District Court.

Defendants filed neither an answer to the complaint nor any affidavits questioning the truth of its allegations. Apart from the complaint itself, only two pieces of evidence were placed before the District Court:

(a) The SEC suspended trading in Atlantic's stock on October 10, 1962. Following that event, and about simultaneously with the institution of this action, Atlantic's board took certain steps which defendants are pleased to call "corrective" or "remedial". Most glaring, however, is the board's failure to take the only action which might really have corrected the wrongs done: It brought no action against the wrongdoers. What the board did do is summarized in a Special Report to Atlantic's stockholders of November 9, 1962 (Sloan pet. 59-62):

> I. The board appointed a Finance Committee consisting of two of the wrongdoers (defendants Johnston and Sloan).
>
> II. The board retained a firm of Washington lawyers to represent Atlantic before the SEC.
>
> III. The board authorized an increase of its membership from five to seven, but failed to appoint any new directors.
>
> IV. The board appointed an Executive Committee, consisting of three of the wrongdoers (Sloan, Schoeffel, Johnston).

V. The board appointed general counsel for Atlantic.

VI. The board arranged to retain accountants.

VII. The board resolved to find, as soon as possible, a new treasurer.

VIII. Scurlock and Sloan guaranteed Atlantic's loans (Sloan pet. 54); but the financial responsibility of these two individuals is highly doubtful.*

IX. Defendant Scurlock was made chairman of the board instead of president; defendant Sloan became vice-chairman and chief executive officer; and an outsider, M. Lee Rice, became president (Sloan pet. 57-58).

None of these "corrective actions" had the slightest tendency to repair the injury defendants had inflicted upon Atlantic.

(b) The only other evidence submitted by defendants was a deposition of the plaintiff. So far as here relevant, plaintiff testified that he had no discussion with his attorney regarding a demand on the board of directors but had decided to proceed without such a demand (Sloan pet. 50-51). He received Atlantic's "Special Report" to its stockholders only after he had verified the complaint (Sloan pet. 50); he did not pay too much attention to it and did not know at his deposition whether the "remedial action" outlined in the report was the same he was requesting in his lawsuit (Sloan pet. 52).

* The Special Report to Atlantic's stockholders points out that, despite the guaranties of Scurlock and Sloan, Atlantic's accountants required the setting up of a substantial reserve against the loans.

ARGUMENT

POINT I

The Petitions Present No Question of Federal Law.

Since this Court's decision in *Swanson* v. *Traer*, 354 U. S. 114 (1957), it is elementary that, in a diversity case such as this, the necessity of a demand on the board of directors and the circumstances excusing such demand are determined by state law.

In the *Swanson* case, the District Court had dismissed the complaint on the ground "that the controversy did not fall within the exceptional group of cases where the stock holder may dispute the management and take the reins of corporate litigation in his own hands" (354 U. S., at 115). The Seventh Circuit did not reach that question but dismissed the action for lack of federal diversity jurisdiction (p. 116). This Court reversed. After rejecting the Seventh Circuit's jurisdictional ruling, it turned to the decision of the District Court and held that, in a diversity case, a stockholder's right to bring a derivative action on behalf of his corporation is governed by "local law," i.e., state law (354 U. S., at 116):

> "There remains for consideration the question ruled on by the District Court and which the Court of Appeals did not reach, viz. whether this suit is of that exceptional character which stockholders may bring.
>
> "As we stated in *Smith* v. *Sperling*, 354 U. S. 91, since our decision in *Erie R. Co.* v. *Tompkins*, 304 U. S. 64, the question whether in these diversity

> suits a stockholder may sue on behalf of his corporation is governed by local law. See *Cohen* v. *Beneficial Loan Corp.*, 337 U. S. 541, 555, 556."

The Court then quoted from *Hawes* v. *Oakland*, 104 U. S. 450, 460 (1882), the conditions under which a minority stockholder may invoke the aid of a court of equity, and proceeded to hold (354 U. S., at 447):

> "Whether local law follows that definition or adopts another and whether this case falls within the one provided by local law is a question on which the Court of Appeals has not ruled. We therefore remand the case to it for consideration of the question."

Upon remand, the Seventh Circuit held that, pursuant to the instructions given by this Court, the demand question must be determined in accordance with the laws of Illinois, under which the corporation was organized: *Swanson* v. *Traer*, 249 F. 2d 854 (Cir. 7, 1958).

Accord: *Hausman* v. *Buckley*, 299 F. 2d 696 (Cir. 2, 1962), cert. den. 369 U. S. 885; *Halprin* v. *Babbitt*, 303 F. 2d 138 (Cir. 1, 1962); *Toebelman* v. *Missouri-Kansas Pipe Line Co.*, 41 F. Supp. 334, 339-340 (D. Del., 1941), rev'd on other grounds but followed on this point, 130 F. 2d 1016, 1022 (Cir. 3, 1942); *Steinberg* v. *Hardy*, 90 F. Supp. 167, 169 (D. Conn., 1950); *Steinberg* v. *Adams*, 90 F. Supp. 604, 609 (SDNY, 1950); *Carruthers* v. *Jack Waite Mining Co.*, 14 F. R. D. 475 (SDNY, 1953); *Pomerant* v. *Clark*, 101 F. Supp. 341, 343 (D. Mass., 1951); *Carroll* v. *N. Y., N. H. & H. R. Co.*, 141 F. Supp. 456, 457 (D. Mass., 1956).

In the present case, the Fourth Circuit held that, applying the law of Virginia, a demand on Atlantic's board of directors was unnecessary (Sloan, et. 24).* This Court, we submit, will not grant certiorari to review a decision adequately based on applicable state law.

POINT II

The Decision Below Presents No Question of General or National Interest.

Whether based on federal or state law, the interlocutory decision rendered by the Court below presents no question of broad or general interest. The decision simply turns on a narrow question of pleading. The Court found that, under the particular facts here alleged, demand on the directors was excused. Other complaints in other cases will present different facts. They will have to be determined on their own merits, and the decision here will be of little, if any, value as a precedent.

It is too elementary for argument that a demand on the directors is unnecessary if all the board members participated in the wrongs complained of. Contrary to petitioners' assertion, the complaint does not just make conclusory charges of non-feasance against some of the directors. On the contrary, it alleges that each of the five defendant directors held substantial amounts of Atlantic's stock and that each of them caused Atlantic to spend $3,900,000 in order to protect their private investments by supporting the declining market. These are clear aver-

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*The Fourth Circuit further held that demand was also excused as a matter of federal law (*ibid.*).

ments of affirmative wrongdoing, which are not open to the criticism of being bare conclusions. It is, therefore, hardly necessary to add that, "Whether these charges be called 'allegations of fact' or 'mere conclusions of the pleader', * * * they must be taken into account in deciding whether [plaintiff] is entitled to have [his] case tried": *United States* v. *Employing Plasterers Ass'n*, 347 U. S. 186, 188 (1954); *Brown* v. *Bullock*, 194 F. Supp. 207, 228 (SDNY, 1961), aff'd 294 F. 2d 415 (Cir. 2, 1961).

Defendants' contention that the decision below "would nullify and destroy the usefulness of Rule 23(b)" is far-fetched, indeed. It is defendants who would emasculate the Rule. Rule 23(b) expressly permits an alternative to the allegation of demand on the directors; the plaintiff may, instead, allege "the reasons for not making such effort". Defendants would read the second alternative out of the Rule. It is difficult to conceive of reasons excusing a demand that are more cogent and persuasive than the participation of all incumbent directors in the wrongs alleged. See *Lecitt* v. *Johnson*, CCH Fed. Sec. Law Reporter, Sec. 91413, p. 94641-2 (Cir. 1, Op. No. 6249, July 8, 1964, not yet otherwise reported).

Petitioners would ascribe to the District Court a finding that Atlantic's board has "an independent and disinterested majority" (Sloan pet. 5). The record contains no such finding* nor any evidence which would support it. On

* In the part of its decision cited by petitioners, the District Court merely held that it was reasonable to speculate—"and it is only speculation"—that the board might have acceded to a demand by plaintiff (Sloan pet. 40). This is a far cry from a finding that the board had an independent and disinterested majority.

the contrary, the allegation of the complaint that all directors participated in the breach of duty stands undenied. It would be absurd to expect the guilty directors to sue themselves. If they did, it would be a mockery of justice to place them in charge of the action.

Defendants pretend to find fault with plaintiff because he did not discuss the demand question with his lawyer. They fail to say why such discussion was necessary when the futility of a demand was so obvious. In any event, the necessity or excuse of a demand depends on its futility, not on the conversations or mental operations of plaintiff and his lawyer.

Equally irrelevant is plaintiff's failure, at his deposition, to remember the details of defendants' so-called "remedial action" set forth in Atlantic's report to its stockholders. As stated, plaintiff received the report *after* he had verified the complaint (Sloan pet. 50). Even had he received it earlier and given it close study, he could have found in it no more than that the "remedial action" was a sham and that the directors, fully apprised of the facts, did not see fit to bring an action, which they would not have been qualified to prosecute in any event.

All these minutiae of evidence were fully considered by the Court below. They are peculiar to this case; none of them is likely to recur in other cases; there exists no warrant for their review by this Court.

POINT III

The Decision Below Is Not in Conflict With Other Authorities.

Defendants assert (Sloan pet. 17-19) that the decision below is in conflict with *Squair* v. *Lookout Mountain Co.*, 42 Fed. 729, 732-3 (E. D. Tenn., 1890); *Watson* v. *United States Sugar Refinery*, 68 Fed. 769, 773 (Cir. 9, 1895); *Ziegler* v. *Lake St. Elev. R. Co.*, 76 Fed. 662, 663 (Cir. 7, 1896); *Shimer* v. *Milton Mfg. Co.*, 10 F. Supp. 943 (M. D. Pa., 1935); *Guth* v. *Groves*, 44 F. Supp. 851 (SDNY, 1942); and *Levitan* v. *Stout*, 97 F. Supp. 105, 114-5 (W. D. Ky., 1951). We submit that none of these cases is pertinent.

The first three (*Squair*, *Watson* and *Ziegler*) were decided prior to the turn of the century under the then effective Equity Rule 94 (104 U. S. IX). While Equity Rule 94 was the predecessor of the present Rule 23(b) FRCP, it differed from the present Rule in a decisive respect: The requirement of a demand on the directors was absolute. Equity Rule 94 did not permit the complaint to allege "the reasons for not making such effort". This alternative clause was added to the Rule in 1912, when it became Equity Rule 27 (226 U. S. 656). The pre-1912 decisions in the *Squair*, *Watson* and *Ziegler* cases are, therefore, obsolete; and they have never been cited with approval by a federal court since 1912.* It is, therefore, unnecessary to point out the sharp factual differences between those cases and that at bar, as well as the fact that none of them involved Virginia law.

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* The *Watson* case was mentioned in *Tower Hill-Connellsville Coke Co.* v. *Piedmont Coal Co.*, 64 F. 2d 817, 825, fn. 1 (Cir. 4, 1933), as one of many cases relied upon by the appellant, which the court found not to be controlling.

Equally inapposite are the three other cases cited by defendants. In *Shimer, supra* (10 F. Supp., at 944), the compiaint merely alleged that the directors were "hostile to the minority interests of stockholders and perform and execute their respective offices and functions in an autocratic, unreasonable and selfish manner". This falls far short of an allegation, such as that made by the present complaint, that the directors participated in the wrongs complained of. The complaint in *Guth, supra* (44 F. Supp., at 854), did charge the directors with complicity, but the court found the charge refuted by the record since the defendants had not been directors at the relevant times. The same was true in *Leviton, supra* (97 F. Supp., at 114-5).

CONCLUSION

It is respectfully submitted that the petitions for certiorari should be denied.

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